12-4671-cv(L)

12-4708-cv(CON), 12-4765-cv(CON), 13-4719-cv(CON), 13-4750-cv(CON), 13-4751-cv(CON), 13-4752-cv(CON), 14-32-cv(CON), 14-117-cv(CON), 14-119-cv(CON), 14-133-cv(CON), 14-157-cv(CON), 14-159-cv(CON), 14-192-cv(CON), 14-197-cv(CON), 14-219-cv(CON), 14-225-cv(CON), 14-241-cv(CON), 14-250-cv(CON), 14-266-cv(CON), 14-303-cv(CON), 14-331-cv(CON), 14-349-cv(CON), 14-404-cv(CON), 14-422-cv(CON), 14-443-cv(CON), 14-480-cv(CON), 14-497-cv(CON), 14-530-cv(CON), 14-567-cv(CON), 14-584-cv(CON), 14-606-cv(CON), 14-663-cv(CON), 14-837-cv(CON)

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

IN RE PAYMENT CARD INTERCHANGE FEE
AND MERCHANT DISCOUNT ANTITRUST LITIGATION

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF NEW YORK

FINAL BRIEF FOR OBJECTORS-APPELLANTS DFS SERVICES LLC, DISCOVER HOME LOANS, INC. AND DISCOVER BANK [REDACTED]

WILLIAM H. PRATT
JENNIFER M. SELENDY
KIRKLAND & ELLIS LLP
601 Lexington Avenue
New York, New York 10022
(212) 446-4800

Attorneys for Objectors-Appellants DFS Services LLC, Discover Home Loans, Inc. and Discover Bank

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PRELIMINARY STATEMENT

This appeal arises out of the settlement agreement in MDL 1720, actions in which plaintiffs, almost exclusively merchants, alleged that Visa and MasterCard engaged in various anti-competitive practices, including the enactment and maintenance of rules that barred merchants from surcharging credit card transactions, in violation of the antitrust laws.

Objector-Appellants DFS Services LLC, Discover Home Loans, Inc., and Discover Bank (together "Discover") — which, among other businesses, operate a payment card network in competition with Visa and MasterCard — are not parties to any of the actions in MDL 1720, did not participate in the negotiation or drafting of the the Definitive Class Settlement Agreement (the "Agreement") at issue here, and rescinded its no-surcharge rule in 2006. Despite Discover's non-party status, the Agreement directly embroils Discover and detrimentally impacts its business in a very significant way. The challenged provisions of the Agreement place unnecessary and anti-competitive burdens on merchants that choose to accept Discover cards along with Visa and MasterCard cards, as most merchants do. As a result, some merchants have already threatened to stop accepting Discover — a lower-cost competitor with a significantly smaller market share — in order to avoid those burdens and to ensure they do not run afoul of the rules put in place by

the largest credit card networks Visa and MasterCard as part of the provisions of the Agreement challenged here.

By approving the Agreement, the district court erroneously sanctioned an illegal agreement in restraint of trade between Visa and MasterCard. Outside the context of a settlement agreement, there is no question that the two largest competitors in a market could not get together and restrict how their customers priced their product based on whether their customers chose also to deal with rivals, *i.e.*, the two largest competitors are not allowed to jointly declare what will be the "level playing field" in an industry. Yet, that is precisely what is occurring here — an illegal group boycott, under the guise of a settlement.

Ironically, although the merchants' case and the Agreement were touted as squarely addressing the anti-competitive network rules maintained and enforced by Visa and MasterCard to prevent merchants from steering consumer credit card volume to lower-priced networks,[1] certain provisions were included by Visa and MasterCard to have quite the opposite effect. The Agreement establishes one set of surcharge rules for merchants that accept only Visa and MasterCard cards and a separate set of more onerous rules for merchants that choose also to accept cards

[1] *See, e.g.*, A859 (Second Consolidated Amended Class Action Complaint) ¶ 3, A879-81 ¶¶ 190-199; Alden L. Atkins and Vincent C. van Panhuys, *Credit Card Fees And Practices Face Antitrust Scrutiny*, Mondaq (Dec. 20, 2012), http://www.mondaq.com/unitedstates/x/212512/Antitrust+Competition/Credit+Card+Fees+And+Practices+Face+Antitrust+Scrutiny.

from additional networks such as Discover. This separate set of rules triggered when a merchant accepts additional networks is euphemistically referred to by Visa and MasterCard as the "Level Playing Field Rules," a term that Discover will use in this brief for consistency. Specifically, Visa and MasterCard, which together account for approximately 70% of credit and charge card transactions, *see* A884 (Second Consolidated Amended Class Action Complaint) ¶ 274, have agreed that, as between themselves, merchants that accept only their cards may steer cardholders to the less-expensive network (whether Visa or MasterCard) by surcharging the other, more expensive network and to publicize this fact, without any further analysis or restriction. By contrast, for merchants that accept other credit card networks or electronic credit payment forms such as Discover, the Agreement imposes a different, far more complicated regime, requiring that merchants perform an analysis of the non-Visa/MasterCard network's rules and operating regulations to determine whether and on what terms surcharging is permissible and then to apply that analysis to any Visa or MasterCard surcharging proposal to determine whether it is permitted under the Agreement. The effect of this Byzantine framework is to impose very significant real-world costs on a merchant's choice to accept networks other than Visa and MasterCard, thereby making it less likely the merchant will do so.

In short, the Agreement has the pernicious effect of interposing the smallest network competitor, Discover, as a costly barrier to merchants' ability to force the intended price competition between larger rivals Visa and MasterCard. Merchants have already indicated that they may opt to drop Discover rather than risk such an interposition.

Beyond harming competition in this way, the Level Playing Field Rules also will undermine one of the key goals of removing Visa's and MasterCard's no-surcharge rules. Historically, Discover has been the low-price network and is the only network with a demonstrated track record of attempting to drive price competition on the merchant side of the network business. Indeed, in the United States' companion antitrust case challenging American Express's anti-steering rules, Discover is a principal witness for the government. A5259 (Declaration of Roger Hochschild ("Hochschild Decl.")) ¶ 24.[2] Discover will testify about the harmful role of anti-steering rules in blocking its primary business strategy of offering lower-priced network services in exchange for a merchants' commitment to steer customers to use Discover-branded cards at their stores. Discover expects the United States to argue that elimination of anti-steering rules will unleash Discover's ability to drive price competition in credit card network services.

[2] *United States v. American Express*, Civ. No 10-04496 (E.D.N.Y. filed Oct. 4, 2010), is scheduled to go to trial this summer before the Honorable Nicholas Garaufis in the United States District Court for the Eastern District of New York, while this appeal is being briefed.

However, unless repealed, the Level Playing Field Rules create so much uncertainty for merchants that these rules will effectively eliminate Discover's ability to lower its prices to merchants in exchange for their agreement to selectively surcharge more expensive networks.

The challenged Level Playing Field Rules are wholly unnecessary to achieve the stated goals of the Agreement, and no pro-competitive justification has ever been offered for them by Visa or MasterCard. The district court's approval of the Agreement was based on the clearly erroneous conclusion that Discover would not be harmed as long as Discover cards were lower-priced than Visa and MasterCard cards to merchants. In fact, even if Discover is lower-priced, the harm will occur — to avoid the harm, the Agreement mandates a "cost of acceptance" comparison that is apples-to-oranges and thus rigged to ensure that Discover will fail even if it is lower-priced. The district court's faulty analysis on this point is inexplicable given that it is crystal clear on the face of the Agreement that "cost of acceptance" for Discover is defined differently than for its rivals, Visa and MasterCard. There is, thus, no legal or factual basis to conclude that Discover is protected from harm if it is lower-priced.

As Discover argued below, the solution is straightforward and would not require wholesale revision of the Agreement. The Agreement should simply remove Discover from the list of "Competitive Credit Card Brands" that the

merchants must consider when applying the Agreement's so-called Level Playing Field Rules. That would eliminate the unfair impact on Discover and would be consistent with the stated intent of the Agreement to abolish restrictions on merchant steering. Significantly, the class merchants support Discover's proposed solution. This Court should reverse and remand with instructions to make the necessary modifications to protect third-party Discover.

JURISDICTIONAL STATEMENT

The district court had jurisdiction over this matter pursuant to 28 U.S.C. §§ 1331 and 1337, which grant district courts jurisdiction over civil actions involving federal antitrust law. On December 13, 2013, the district court entered a Memorandum and Order that granted final approval to the class action settlement between the parties. By Notice of Appeal filed on December 19, 2013, Discover appealed from that Memorandum and Order. This Court has appellate jurisdiction pursuant to 28 U.S.C. § 1291, which grants courts of appeals (other than the United States Court of Appeals for the Federal Circuit) "jurisdiction of appeals from all final decisions of the district courts of the United States."

ISSUES PRESENTED FOR REVIEW

1. Did the district court adequately consider the fairness of the Agreement to non-party Discover before granting final approval?

2. Did the district court abuse its discretion by approving a settlement agreement that harms competition and under which Visa and MasterCard have agreed to boycott any merchant that deals with rivals unless these dealings are under terms and conditions dictated by Visa and MasterCard?

STATEMENT OF THE CASE

Prior to consolidation into MDL 1720, two separate classes of merchants and trade associations, along with individual merchants bringing suit on their own, filed antitrust complaints against Visa, MasterCard, and their member banks (now issuing and acquiring banks) for price fixing and maintaining anti-competitive rules that, among other things, prevented merchants from steering credit card volume to lower-cost networks by surcharging the higher-cost networks. In October 2005, these cases were consolidated in the United States District Court for the Eastern District of New York and assigned to the Honorable John Gleeson. A822-24. After over five years of litigation, the parties announced on July 13, 2012, that they had reached a settlement agreement in principle and filed a Memorandum of Understanding. A1042-60. The Agreement that forms the basis of this appeal was executed by the parties in October 2012. SPA98-201. On October 19, 2012, class counsel moved for preliminary approval of the Agreement. A1086-87.

On November 27, 2012, the district court granted preliminary approval of the Agreement and certified two settlement classes: (1) a Rule 23(b)(3) damages class, which permitted opt-outs; and (2) a mandatory Rule 23(b)(2) injunctive relief class, which did not permit opt-outs. A1100-10.

On May 28, 2013, Discover moved to intervene in MDL 1720. A2249-51.[3] The parties did not object to Discover's request to intervene and, with the district court's approval, treated Discover's brief in support of intervention as Discover's statement of objections to the Agreement. A2433; A2434.

On September 12, 2013, the District Court held a fairness hearing on the parties' motion for final approval of the settlement. At the fairness hearing, Discover explained how the so-called Level Playing Field Rules in the Agreement amounted to an illegal group boycott. Despite this glaring problem, and the thousands of objections submitted by merchants, competitors, consumer groups, states, and trade associations, on December 13, 2013, the district court nevertheless issued a Memorandum and Order certifying the Rule 23(b)(2) and 23(b)(3) settlement classes and granting final approval to the settlement. SPA1-55.[4] This appeal followed.

A. Discover's Long History of Offering Lower Prices to Merchants

The Discover® Network was launched in 1986 by Sears Roebuck & Co. to provide a more merchant-friendly card payment option in the United States. A5251 (Hochschild Decl.) ¶ 2. Discover's strategy was to shift market share away

[3] In conjunction with its Motion to Intervene, Discover filed a separate set of objections to the Agreement based on Discover's inclusion as a class member. A2263-76. Discover also filed a notice of intent to opt-out of the Rule 23(b)(3) damages class. A2277.

[4] A separate Class Settlement Order and Final Judgment, reiterating the District Court's findings from the December 13, 2013 Memorandum and Order, was entered on January 14, 2014. SPA73-96.

from Visa, MasterCard, and American Express by offering lower prices to merchants, as well as by offering innovative new features — such as no annual fee and cash back rewards — to consumers that chose to carry a Discover® Card. *Id.* Discover's low-price strategy allowed it to open up a number of merchant categories that had never before agreed to accept credit cards, including warehouse clubs and grocery stores. A5252 ¶ 3. Importantly, Discover also opened up credit card acceptance at government agencies and universities specifically by allowing surcharging, and MasterCard soon followed. *Id.* ¶ 4. Throughout the 1990s, Discover had a policy of "meet or beat pricing" that allowed its merchant sales force to ensure that Discover's pricing was always at or below the competition's pricing. A5251 ¶ 2. From the time of its launch, Discover faced a withering attack from its network competitors designed to interfere with Discover's merchant relationships. *See* A5252 ¶ 5. Over the years, Discover offered numerous "share shift" proposals to larger merchants that were specifically designed to incentivize merchants through lower pricing to steer volume to Discover. *See* A5253 ¶¶ 6-7. However, because of "anti-steering" rules maintained by the larger networks, merchants were not able to steer their customers to use Discover, even where to do so would have benefitted both the cardholder and the merchant. *See id*.

Discover eventually concluded that it could not capitalize on its low-price merchant strategy because of interference by its larger rivals and their anti-

competitive rules that barred merchant steering, so Discover thereafter began raising its pricing to merchants to be more comparable to that of Visa and MasterCard, but still below that of American Express. *Id.* ¶ 8. Even with this change in pricing strategy, however, Discover has consistently maintained its strong policy of partnering with merchants and offering innovative and merchant-friendly programs to promote the use of Discover. *Id*.

When Discover learned that defendants' "anti-steering" rules might be eliminated through a settlement in this case, Discover hoped that the settlement would allow it to revive its strategy of offering low prices to merchants in order to shift market share away from Visa and MasterCard and to Discover. A5254 ¶ 10. Following a series of communications from merchants, however, Discover came to realize that what was contemplated in the Agreement was not a simple elimination of Visa's and MasterCard's anti-steering rules, but rather a new roadblock to competition from Discover and, what's worse, a complex set of rules that would unavoidably embroil Discover in any merchant attempts to force Visa and MasterCard to compete on price.

The complex new structure created one set of rules for merchants that accept Visa and MasterCard only and a second more onerous set of rules for the vast majority of merchants that also accept rival card networks such as Discover. Discover realized that if the Agreement actually went into effect as written,

Discover would be significantly disadvantaged as a network relative to Visa and MasterCard in the battle for merchant business. *See* A5256-59 ¶¶ 16-20, 23.

With only about 6% of credit and charge card transactions, Discover lacks the market power of Visa and MasterCard to ensure merchant acceptance of its cards. While Visa and MasterCard simply dictate their terms of acceptance to merchants, and once the brand is accepted, it cannot be dropped, [redacted].[5] Moreover, the Agreement effectively precludes price competition initiated by Discover because it unfairly dictates how merchants are to calculate Discover's cost of acceptance to ensure that Discover will always "appear" to be the more expensive network.

After it was unsuccessful in addressing its concerns with the MDL 1720 parties, Discover intervened in the proceedings below and objected to the provisions of the Agreement that competitively disadvantaged Discover. A2263-

[5] Moreover, because the Agreement would make Discover's network less competitive, including by threatening merchant acceptance, it also imposes harm on Discover Bank as the largest issuer on Discover's network. Cardholders will be less interested in carrying Discover credit cards if Discover's merchant acceptance decreases or it is unable to compete on equal terms to benefit from merchant steering.

76. Discover also submitted evidence in the district court demonstrating how Discover's merchant acceptance has been severely hampered in the past by the conduct of rivals imposing even relatively small additional costs on merchants for accepting Discover. No party controverted Discover's evidence. Yet, the district court glossed over Discover's objections in a mere four sentences in the Memorandum and Order approving the Agreement.

B. The Agreement's "Double Standard" for Merchants That Accept Only Visa and MasterCard and for Merchants That Also Accept Other Networks Such as Discover

The Agreement does not accomplish its stated goal of enhancing network competition by eliminating Visa's and MasterCard's "anti-steering" rules. Indeed, the class merchants quickly recognized this fact and actually supported Discover's proposal in the district court to remove Discover from the definition of a Competitive Credit Card Brand subject to the Level Playing Field Rules. *See* A2579-80 (9/12/13 Fairness Hearing Tr.). Instead of unleashing competition, the Agreement impairs it by creating one set of rules for merchants that accept only Visa and MasterCard and a separate set of rules for merchants that choose also to accept additional networks such as Discover.[6] Although the first set of rules is not difficult for merchants to apply, the second set is confusing and burdensome to

[6] This double standard is crystal clear in the Notice of Class Action Settlement Authorized by the U.S. District Court, Eastern District of New York. *See* A5268 (Ex. 1 to the Hochschild Decl.) ("What do the members of the Rules Changes Settlement Class get?").

understand and apply. The effect of the two sets of rules is to create vast uncertainty for merchants, making it more costly for merchants that accept networks other than Visa and MasterCard to deal with those dominant networks and chilling efforts by merchants that accept additional networks to steer transactions away from Visa and MasterCard through surcharging.

Generally, merchants are permitted under the Agreement to surcharge Visa or MasterCard credit card transactions on either a brand level (all Visa cards) or product level (*e.g.*, only Visa "premium" cards), so long as the surcharge is not higher than the merchant's "cost of acceptance" for Visa and MasterCard, as defined in the Agreement. Such surcharging is subject to rules regarding prior written notice, disclosure at the store, inclusion of the surcharge on the receipt, and other such provisions. *See, e.g.*, SPA 148 (Definitive Class Settlement Agreement ("Agreement") ¶ 42(c), SPA 161-62 ¶ 55(c).

If Visa and MasterCard are the only two credit card networks or electronic credit payment forms accepted by a merchant (*e.g.*, American Express, Discover, and PayPal are not accepted), there are no other limitations on merchant surcharging. Thus, Visa and MasterCard have agreed that, as between themselves, they will not impose additional steering restraints on merchants that accept only their cards. These merchants may steer cardholders by surcharging the more

expensive network — either Visa or MasterCard — and to publicize this fact, without any further analysis or restriction.

For merchants that decide to accept other credit card networks or electronic credit payment forms such as Discover, however, the Agreement imposes a different regime. *See* SPA141 ¶ 42(a)(iv), SPA154-55 ¶ 55(a)(iv). For these merchants, if another "Competitive Credit Card Brand" — which is defined in the Agreement as explicitly including Discover — "***limit[s] in any manner***" a merchant's ability to surcharge the Competitive Credit Card Brand, merchants may surcharge a Visa or MasterCard transaction only on the "terms on which the merchant actually does" surcharge the other network's transactions or on the "same conditions on which the merchant would be allowed to surcharge transactions." *Id*. (emphasis added). The full provision with respect to Visa, Agreement ¶ 42(a)(iv), states:

> If a merchant's ability to surcharge any Competitive Credit Card Brand that the merchant accepts in a channel of commerce (either face-to-face or not face-to-face) is limited in any manner by that Competitive Credit Card Brand, other than by prohibiting a surcharge greater than the Competitive Credit Card Brand's Cost of Acceptance, then the merchant may surcharge Visa Credit Card Transactions, consistent with the other terms of this Paragraph 42(a), only on either the same conditions on which the merchant would be allowed to surcharge transactions of that Competitive Credit Card Brand in the same channel of commerce, or on the terms on which the merchant actually does surcharge transactions of that Competitive Credit Card Brand in the same channel of

> commerce, after accounting for any discounts or rebates offered at the point of sale.

SPA 141. (A parallel provision with respect to MasterCard is located at SPA154-55 ¶ 55(a)(iv).) Visa and MasterCard dubbed these rules the "Level Playing Field Rules" — a title that is inaccurate in suggesting that they are creating an actual level playing field among all the network competitors. The terms do, however, reflect that the rules are directed toward rival networks and seek to limit the ways in which merchants can deal with those networks.

C. The Agreement's Requirement That Merchants Perform a Burdensome and Ill-Defined Analysis of Whether Discover Limits "in Any Way" the Merchants' Ability to Surcharge

Unlike the situation when merchants choose to accept only Visa and MasterCard, a merchant that seeks also to accept other networks must first determine whether its ability to surcharge that Competitive Credit Card Brand "is limited in any manner" by the Competitive Credit Card Brand and, if so, may surcharge Visa and MasterCard only on those same conditions. The Agreement's vague mandate requires an interested merchant to undertake a laborious and ill-defined analysis. First, the term "limited in any manner" is not defined in the Agreement and thus requires the merchant to assess — or, essentially, to guess — what practices of the Competitive Credit Card Brand Visa and MasterCard might consider to be a limitation "in any manner" on the ability to surcharge the Competitive Credit Card Brand. Merchants are left to guess whether advertising or

website pronouncements by the Competitive Credit Card Brand might qualify as such a limitation, or whether they must only look to the other network's rules or contracts. Further, in the case of Discover, merchants might also query whether Discover has private contract terms with any of its merchants that could constitute limitations within the meaning of the Agreement. Second, and at the very minimum, the merchant must scour the Competitive Credit Card Brand's merchant rules — typically voluminous and not normally read or applied by the merchant in the ordinary course of business — to identify which rules might be viewed as a limitation on the ability to surcharge. Third, the merchant must assess the consequences to it of applying that same "limitation" to Visa and/or MasterCard (as well as the Competitive Credit Card Brand).

One example from Discover's rules, which has been brought to Discover's attention by merchants, demonstrates that the threat to Discover from the Level Playing Field Rules is real and immediate. Discover maintains an "Equal Treatment Rule" to preclude discrimination or unfair treatment by merchants. Discover submitted evidence demonstrating that this rule was adopted in direct response to actions taken over the years by Visa and MasterCard to induce merchants to block network competition from Discover, which offered prices that were substantially lower than Visa or MasterCard for many years. Those actions included such steps as, in the years immediately following Discover's launch, Visa's precluding merchants from processing Discover transactions on the same point-of-sale terminals that processed Visa, MasterCard, and American Express transactions. A5252-53 (Hochschild Decl.) ¶ 5, A5258 ¶ 21. Discover's evidence regarding the importance of its Equal Treatment Rule was not disputed by any party below.

Although Discover's Equal Treatment Rule is aimed at ensuring that merchants treat Discover on equal terms as the dominant Visa and MasterCard, several merchants brought to Discover's attention the fact that the Equal Treatment Rule might be viewed as a "limitation" on surcharging within the meaning of the Agreement because it would prohibit selective and discriminatory surcharges against Discover when higher-priced networks are not surcharged. [redacted]

[redacted]

Merchants specifically indicated that, because Discover's Equal Treatment Rule could limit surcharges against Discover where Discover matches or beats the pricing of a rival that is not surcharged, *id.*, Visa and MasterCard, under the Level Playing Field Rules, could seek effectively to "borrow" Discover's Equal Treatment Rule to prevent a merchant from assessing surcharges against them — the exact opposite of what the Agreement is intended to accomplish. As an illustration, assume a transaction that does not involve Discover at all where Visa charged a merchant 200 basis points in interchange and fees, while MasterCard charged the merchant 180 basis points. In negotiations with merchants, Visa might offer to charge the merchants 185 basis points so long as the merchant surcharged MasterCard. (For a merchant, the savings from lower costs for the higher-share Visa network may more than offset any loss from having volume shift from the lower-priced MasterCard network to the higher-priced Visa.) If the merchant accepted Discover, however, MasterCard might seek to block Visa's proposal by invoking the Level Playing Field Rules and inserting Discover's rules into negotiations in which they should have no role. MasterCard would argue that: (a) Discover's Equal Treatment Rule prevents a merchant from surcharging Discover when Discover's pricing is lower than its competitors; (b) Discover's Equal

Treatment Rule accordingly "limits in any manner" the merchant's ability to surcharge Discover; and (c) pursuant to the Level Playing Field Rules, that limit on the merchant's ability to surcharge Discover applied equally to MasterCard; and (d) thus, the merchant is prevented from agreeing to Visa's proposal (which would involve the merchant surcharging the lower-cost MasterCard).

This possible scenario involving Discover's Equal Treatment Rule (but not Discover) is just one source of the uncertainty facing merchants that accept Discover and are contemplating a surcharge on Visa and MasterCard under the Agreement. The merchants cannot predict how Visa and MasterCard may interpret or apply Discover's Equal Treatment Rule or any other rule or practice of Discover that Visa and MasterCard might assert is a "limitation" on the merchants' ability to surcharge.

D. The Agreement's Ineffectual Exceptions to the Level Playing Field Rules

In the court below, Visa and MasterCard responded to Discover's concerns about the Level Playing Field Rules by asserting that the Agreement included two purported exceptions to those rules that could exempt Discover. Neither exception, however, has any practical value or significance. The "cost of acceptance" exception affirmatively discriminates against Discover by calculating the cost of accepting Discover differently from the analogous calculation for Visa and MasterCard. The "contracting out" exception is so complicated, burdensome, and ill-suited to Discover's unique business model that it cannot be used in practice. Notably, no merchant has indicated that these purported exceptions alleviate the concerns that they have about dealing with Discover in the face of the Level Playing Field Rules.

1. The Purported "Cost of Acceptance" Exception

When rejecting Discover's objection to the Level Playing Field Rules, the district court noted that Discover "will not be affected" by those rules "to the extent that Discover Cards are lower-priced than Visa and MasterCard products." SPA50 (Memorandum and Order). Presumably, the district court was referring to paragraphs 42(a)(v)(A) and 55(a)(v)(A) of the Agreement (the "Cost of Acceptance Exception"), which provide that the Level Playing Fields Rules would not apply to Discover if Discover's "Credit Card Cost of Acceptance to the

merchant is less than the MasterCard and/or Visa Credit Card Cost of Acceptance to that merchant" (*i.e.*, if Discover is cheaper to the merchant than its rivals). The district court appears to have relied on the representation of counsel for Visa and MasterCard at the settlement hearing that, "[i]f Discover is less expensive than MasterCard and Visa, whichever one is applicable in that case, then the level playing field doesn't apply." A2582 (9/12/13 Fairness Hearing Tr.).[7] As discussed below, however, although Discover ***is*** less expensive, it would be impossible to demonstrate that fact through the rigged cost comparison built into the Cost of Acceptance Exception.

Setting aside that the very need to undertake these burdensome and uncertain calculations lead merchants simply to drop Discover, the comparison itself is rigged against Discover. The comparison is an apples-to-oranges cost comparison that includes ***extra*** costs for Discover when comparing it to Visa and MasterCard.[8]

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[7] Counsel for Visa and MasterCard also erroneously asserted that Discover's Equal Treatment Rule is "more restrictive" than the Level Playing Field Rules and "says, in essence, 'To the extent that you surcharge Discover, you got to to surcharge every other card because it says we can't be treated differently.'" A2583 (9/12/13 Fairness Hearing Tr.). In fact, the Equal Treatment Rule is designed to protect Discover from discriminatory treatment by the two largest networks Visa and MasterCard. With respect to surcharges, Discover's Equal Treatment Rule would not require every card be surcharged equally; rather, it would merely prevent Discover's being surcharged when its prices are lower than a non-surcharged rival (*i.e.*, where a surcharge of Discover would be discriminatory) or when all other networks maintain rules against surcharging (as they did from 2006 to 2012). A5258 (Hochschild Decl.) ¶ 22.

[8] For Visa or MasterCard, the cost comparison is based on their "average effective interchange fee." SPA141-44 (Agreement) ¶ 42(a), SPA154-57 ¶ 55(a) (definitions of Visa Credit Card Cost of Acceptance and MasterCard Cost of Acceptance, respectively). For Discover, by contrast, the cost comparison is based on the "average Merchant Discount Rate," not the average effective interchange fee. *Id.* (definition of Competitive Credit Card Cost of Acceptance). This difference in how each company's cost is defined for purposes of the cost comparison is outcome determinative because

As a result of this apples-to-oranges comparison, when a merchant seeks to apply the Cost of Acceptance Exception, the comparison invariably would result in a finding that Discover is higher cost and therefore the Cost of Acceptance Exception never satisfied.[9]

Even if the purported Cost of Acceptance Exception were not rigged and did, in fact, involve an apples-to-apples cost comparison, the exception has real-world, practical deficiencies that underscore its unfairness and other inefficacy. Different networks have different card products and implement fee structures in slightly different ways. Many of Discover's largest merchants therefore have indicated that they are unable to compare Discover's pricing with that offered by Visa and MasterCard. A5256 (Hochschild Decl.) ¶ 16. Indeed, several years ago,

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Discover's defined cost includes the acquirer's mark-up on top of the average interchange fee. *Id.* (definition of Merchant Discount Rate includes "acquirer set processing fees associated with the processing of a transaction"). The acquirer mark-up is substantial, in the range of 30 to 50 basis points (0.3% to 0.5%) per transaction. A5257-58 (Hochschild Decl.) ¶ 20. Because Discover's defined costs include this acquirer mark-up (while Visa's and MasterCard's defined costs do not), Discover could be lower-cost and yet this cost comparison would find it to be higher-cost. Indeed, Discover would have to be 30 to 50 basis points lower in price before the Agreement's comparison would actually consider it to be lower-cost. That is an enormous difference in this industry. By way of comparison, the Settlement Agreement is trumpeting the fact that merchants' Visa and MasterCard interchange fees will be lowered by 10 basis points for eight months. SPA122-23 ¶ 13. In short, the cost comparison is apples-to-oranges and thus rigged for Discover to fail.

[9] To apply the Cost of Acceptance Exception, a merchant is required, among other things, to calculate the Visa and MasterCard Credit Card "Cost of Acceptance," as defined in the Agreement. SPA141-44 ¶ 42(a), SPA154-57 ¶ 55(a). Virtually conceding the burden, if not the practical impossibility, of a merchant's calculating this Cost of Acceptance, other provisions of the Agreement allow merchants simply to use a specified surcharge cap as their permissible surcharges to Visa and MasterCard — the Maximum Surcharge Cap. These caps are posted by Visa or MasterCard on its website and do not require convoluted calculations. SPA141 ¶ 42(a)(iii), SPA154 ¶ 55(a)(iii). The fact that the Agreement includes these less burdensome alternatives for Visa and MasterCard further highlights the burdensome nature of the purported Cost of Acceptance Exception.

Discover overhauled its pricing structure to disaggregate fees in a way that would better allow cost comparisons. *Id.* Discover thought that a more transparent cost comparison would work to its advantage because it is lower-cost. Discover nonetheless continues to hear from merchants that they struggle to conduct such comparisons given the complexity of Visa's and MasterCard's plethora of card products and complex pricing.[10] *Id.* This reality makes the purported exception unworkable from a practical point of view even if it were apples-to-apples. Because these practical problems are obvious to Visa and MasterCard as operators of credit card networks, Discover can only conclude that the exception is intended to be ineffective. There was no evidence offered below controverting these real-world barriers to a meaningful and fair cost-of-acceptance comparison.

There is yet another subtle, but nonetheless fatal, flaw in this purported exception that creates extreme unfairness for Discover. Visa and MasterCard set pricing by product types and have a large number of pricing categories and very different volume profiles than Discover. A5257 (Hochschild Decl.) ¶ 18.

[10] As just one example, Discover's pricing in a single "commercial" category would need to be compared to a dozen or more different Visa and MasterCard premium, business, and corporate pricing categories with different rates for each category. A5256-57 (Hochschild Decl.) ¶ 17. Discover's 1,300 retained merchants would presumably need to analyze the number of transactions that it receives in each of the numerous Visa and MasterCard pricing categories and prepare a blended average cost to compare to Discover's single commercial product rate. *Id.* This problem is exacerbated by the fact that the merchants would also need somehow to separate out credit and debit products for Visa and MasterCard, and also find a way to account for fees that apply depending on the nature of the transaction (e.g., card not present) or whether or not a merchant complies with certain network rules, in order to compare credit cost of acceptance for the different networks. *Id.* [redacted]

Therefore, on a blended average basis, a cost calculation for Visa and MasterCard-branded cards could be less expensive due to the substantial number of non-rewards Visa and MasterCard-branded cards in circulation. *Id.* A fair cost comparison would require that merchants compare truly comparable products, *i.e.*, compare rewards cards to rewards cards. If done that way, Discover's rewards and commercial cards are almost always less expensive to merchants than comparable rewards and commercial card products offered by Visa and MasterCard issuers. *See id.* ¶ 19. But that is not the way the exception is calculated, meaning that Discover's greater proportion of rewards cards would cause it to "fail" the cost comparison even if it was not already rigged against Discover. Again, there was no countervailing evidence submitted below on this point.

Accordingly, for all of the reasons stated above, it is clear that the Cost of Acceptance Exception does not mandate anything close to a fair, apples-to-apples comparison of Discover costs to merchants versus those of Visa and MasterCard and therefore, as a practical matter, is no exception at all. There is no justification for allowing the two largest competitors to impose "level playing field" hurdles on a small rival network, let alone create such a rigged and unfair comparison. Thus, the district court's conclusion that Discover would not be affected by the Agreement as long as its prices were lower than Visa and MasterCard was clearly

erroneous — and that clearly erroneous conclusion was the sole ground on which the district court ruled that the Agreement would not unduly harm Discover.

2. The Purported "Contracting Out" Exception

Paragraphs 42(a)(v)(C) and 55(a)(v)(C) of the Agreement (the "Contracting Out Exception") purport to except the merchant from the burden of having to analyze and apply Discover's rules and operating regulations pursuant to the Level Playing Field Rules if the merchant first reaches agreement with Discover to waive any right to surcharge it. SPA142 ¶ 42(a)(v)(C) and SPA155 ¶ 55(a)(v)(C). However, to satisfy the Contracting-Out Exception, Discover and its merchant customer must meet six conditions — which when considered together are so confusing and burdensome that reaching agreement under that exception is untenable.[11] The bad faith intent behind this exception is highlighted by the fact that, when the Agreement elsewhere sets forth the requirements that Visa and MasterCard must follow when they negotiate a surcharge waiver agreement with merchants, it imposes ***two fewer*** conditions on Visa and MasterCard than what

[11] According to paragraphs 42(a)(v)(C) and 55(a)(v)(C) of the Agreement (SPA142 and SPA155), any surcharge waiver agreement between Discover and a merchant much satisfy the following requirements: (I) the agreement is for a fixed duration, is not subject to an evergreen clause, and is individually negotiated with the merchant and is not a standard agreement or part of a standard agreement generally offered by the Competitive Credit Card Brand to multiple merchants; (II) the merchant's acceptance of the Competitive Credit Card Brand as payment for goods and services is unrelated to and not conditioned upon the merchant's entry into such an agreement, (III) any such agreement or waiver is supported by Independent Consideration, and (IV) the agreement expressly specifies a price under which the merchant may accept transactions on the Competitive Card Brand and surcharge those transactions up to the merchants' Merchant Discount Rate for the Competitive Card Brand, after accounting for any discounts or rebates offered by the merchant at the point of sale.

applies to Discover and other rival networks. *Compare* SPA149 ¶ 42(f), SPA162-63 ¶ 55(f), *with* SPA142 ¶ 42(a)(v)(C) and SPA155 ¶ 55(a)(v)(C).[12]

One of the conditions that would apply to Discover, but not to Visa and MasterCard, in having a surcharge waiver agreement meet the exception would require that the waiver be unrelated to the merchant agreeing to accept Discover. SPA142 (Agreement) ¶ 42(a)(v)(C)(II), SPA155 ¶ 55(a)(v)(C)(II) (stating as a condition that "the merchant's acceptance of the Competitive Credit Card Brand as payment for goods and services is unrelated to and not conditioned upon the merchant's entry into such an agreement"). This condition is uniquely harmful to Discover's business relationships with hundreds of its largest merchants because, unlike Visa and MasterCard, Discover's business model involves entering into individually-negotiated agreements with merchants and acquirers that embody all the terms and conditions of the parties' relationships, including agreeing to accept Discover. A5254 (Hochschild Decl.) ¶ 12. [redacted]

[12] Craftily, both sets of provisions are drafted to appear to include four Roman-numeraled provisions in each. But note that Subparagraphs I, II, and III of the Visa/MasterCard conditions are all combined into Subparagraph I of the Discover conditions, however, meaning that Discover is subject to six conditions while Visa/MasterCard are subject to only four.

[redacted][13]

Remarkably, the quoted language from subparagraphs 42(v)(C)(II) and 55(v)(C)(II) that Visa and MasterCard seek to impose on Discover is copied directly from the Department of Justice consent decree with Visa and MasterCard, *see* Final Judgment, Section IV.B.3, *United States v. American Express Co.*, Civ. No. 10-4496, D.E. 143, dated July 20, 2011, settling the Department of Justice's antitrust claims against them relating to the same anti-competitive anti-steering rules at issue in MDL 1720. The Department of Justice required that provision of Visa and MasterCard because, unlike Discover and its individually-negotiated merchant contracts, Visa and MasterCard ordinarily present their merchants with standardized contracts of adhesion, and the Department of Justice wanted to ensure that MasterCard and Visa negotiated this provision individually with merchants. With respect to Discover, and its business model of individualized negotiations with merchants, however, the provision imposes an impermissible and anti-competitive cost to require a second, separate individualized negotiation with respect to surcharging. In addition, there is no basis to impose on Discover, which

[13] Although Visa and MasterCard are subject to subparagraphs 42(a)(v)(C)(III) and 55(a)(v)(C)(III), respectively, the requirement that Discover support any surcharge waiver agreement with "Independent Consideration" also harms Discover in unique ways because Discover already independently contracts with each of its largest merchants and provides consideration for all terms in its agreements.

has not been accused of antitrust violations, the same corrective terms that were imposed on Visa and MasterCard by the Department of Justice as a result of their being sued as antitrust violators.

The second condition that would apply to Discover, but not to Visa and MasterCard, is so opaque that it is virtually impossible to understand and follow. It reads: "the agreement expressly specifies a price under which the merchant may accept transactions on the Competitive Card Brand and surcharge those transactions up to the merchants' Merchant Discount Rate for the Competitive Card Brand, after accounting for any discounts or rebates offered by the merchant at the point of sale." SPA142 (Agreement) ¶ 42(a)(v)(C)(IV), SPA155 ¶ 55(a)(v)(C)(IV). Discover does not even understand what this provision means, and no party offered any explanation or justification for this provision to the court below. Visa and MasterCard should not have the right to dictate how Discover contracts with its merchants. With no explanation of the meaning of subparagraphs 42(a)(v)(C)(IV) and 55(a)(v)(C)(IV), and no understanding of its own, Discover is effectively precluded from taking advantage of the Contracting Out Exception and again is faced with the anti-competitive impact of the Level Playing Field Rules.

E. The Agreement Effectively Precludes Price Competition from Discover.

One of the Agreement's stated purposes is to permit greater surcharging so as to enhance network price competition for merchants. It is uncontroverted that Discover is the only credit card network that has pursued a strategy of initiating price competition on the merchant side of the business in order to win transaction volume. Yet, the Level Playing Field Rules will effectively bar Discover from lowering its prices in exchange for a commitment from merchants to surcharge Visa and/or MasterCard.

If permitted, Discover is interested in offering merchants lower pricing in exchange for merchants steering volume to Discover through surcharging, and it initially explored such options when the Agreement was first announced. A5254 (Hochschild Decl.) ¶ 10. But because the Level Playing Field Rules require merchants to "borrow" Discover's Equal Treatment Rule, it will permit Visa and MasterCard to be surcharged under such a Discover strategy only if Discover is recognized under the Agreement as being lower-priced. Although Discover in reality would almost certainly be lower-priced under such a strategy, as discussed in the prior section, the Agreement's "cost of acceptance" comparison is rigged to find that Discover is not lower-priced. [redacted]

[redacted]

The apples-to-oranges "cost comparison" therefore will not only do nothing to alleviate the anti-competitive harm imposed on Discover because of the Level Playing Field Rules, it will also preclude Discover's ability to compete more effectively. It is hard to imagine any clearer indication of intent on the part of Visa and MasterCard to ensure that the Agreement does not actually result in price competition through a practice of merchants surcharging more expensive networks.

F. Discover Lacks Market Power, Cannot Create an Unlevel Playing Field for Visa and MasterCard, and Needs Its Equal Treatment Rule.

For merchants interested in surcharging, the Level Playing Field Rules are a labyrinth and a burdensome hassle. [redacted]

[redacted]

We anticipate that MasterCard and Visa will contend that the Level Playing Field Rules must apply to Discover because otherwise it would be free to raise prices on merchants and/or interpret its Equal Treatment Rule to preclude a surcharge of Discover. This argument is frivolous. Discover is subject to market discipline in ways that Visa and MasterCard, with their market power, are not. [redacted]

Given Discover's low market share and long history of attempting to drive price competition, it is far-fetched for Visa and MasterCard to contend that applying the Level Playing Field Rules to Discover is necessary to prevent high pricing.

Nor is there any merit to claiming that Discover could address its problems "costlessly" by eliminating its Equal Treatment Rule. If Discover could simply deal with all the problems described in this brief without cost by eliminating its

Equal Treatment Rule, there would have been no need to become embroiled in two years of industry-wide litigation over the Agreement. Discover has a uncontroverted need for its rule because of its vulnerable market position. Indeed, the genesis of Discover's Equal Treatment Rule was unfair and discriminatory treatment at the hands of its rivals.

For example, in the years immediately following Discover's launch, Visa precluded merchants from processing Discover transactions on the same terminals that processed Visa, MasterCard, and American Express transactions, forcing Discover to give away new terminals to merchants that could process all transactions. A5252 (Hochschild Decl.) ¶ 5. In the late 1980s, the larger networks, including Visa and MasterCard, actively enforced anti-steering rules that precluded merchants from trying to steer consumers to use Discover-branded cards through surcharging or by other means. *Id.* In the 1990s, Visa and MasterCard adopted rules that prohibited banks that issued Visa and/or MasterCard cards from also issuing Discover cards. *Id.* [redacted]

[redacted] To eliminate the Equal Treatment Rule would mean exposing Discover to the various forms of discrimination that it has been exposed to in the past.

Should Discover have to drop its Equal Treatment Rule to maintain merchant acceptance, the Agreement would, in effect, have allowed the dominant networks to create "level playing field" rules they do not need, while forcing Discover to change the way it does business to its detriment. Nothing in the law permits the two largest firms in an industry to use the guise of a settlement jointly to implement rules designed to change the way smaller competitors operate to their disadvantage.

SUMMARY OF ARGUMENT

The district court abused its discretion in approving the Agreement because it failed to recognize the unjust harm to non-party Discover and Discover's relationships with its merchants caused by the Agreement's Level Playing Field Rules. Rather than promoting the Agreement's goal of enhancing network competition, the Level Playing Field Rules will unfairly and unlawfully hinder Discover's ability to compete with Visa and MasterCard. The application of those rules to Discover is not an integral part of the Agreement, and Discover can readily be removed from the ambit of those rules, without affecting the Agreement's purpose — to curb the anti-competitive practices of the two largest credit card networks, Visa and MasterCard.

The district court also abused its discretion by approving conduct by Visa and MasterCard, as reflected in the Agreement, that is a clear violation of Section 1 of the Sherman Act. Under the Agreement, Visa and MasterCard have entered into an agreement whereby they will refuse to deal with any merchant unless that merchant implements surcharging in a manner dictated by them and that will disadvantage Discover, a rival competing network. The rules reflecting this Agreement — the Level Playing Field Rules — constitute a group boycott: an agreement in which a group of competitors use their dealings with suppliers or customers to disadvantage rivals. Particularly where, as here, there are no pro-

competitive benefits to the group boycott or collective refusal to deal, courts have long held such joint action to be *per se* illegal under the Sherman Act.

STANDARD OF REVIEW

This court reviews a district court's decision to approve a proposed settlement of a class action for abuse of discretion. *See, e.g.*, *Joel A. v. Giuliani*, 218 F.3d 132, 139 (2d Cir. 2000). A district court "abuses" or "exceeds" its discretion when (1) its decision rests on an error of law or a clearly erroneous factual finding, or (2) its decision cannot be located within the range of permissible decisions. *In re Literary Works in Elec. Databases Copyright Litig.*, 654 F.3d 242, 249 (2d Cir. 2011). Where, as in MDL 1720, a court is asked to certify a class and approve a settlement, the Rule 23(a) requirements "designed to protect absent class members 'demand undiluted, even heightened, attention.'" *Id.* (quoting *Amchem Prods., Inc. v. Windsor*, 521 U.S. 591, 620 (1997)).

ARGUMENT

I. THE DISTRICT COURT IMPROPERLY GRANTED FINAL APPROVAL TO A SETTLEMENT AGREEMENT THAT IS UNFAIR AND DETRIMENTAL TO A THIRD PARTY.

This Court has, on multiple occasions, instructed district courts that they must be cognizant of the rights of third parties when determining whether to approve a settlement and cannot focus exclusively on the fairness of the settlement to the settling parties. *See, e.g., In re Master Mates & Pilots Pension Plan & IRAP Litig.*, 957 F.2d 1020, 1026 (2d Cir. 1992) ("[W]here the rights of one who is not a party to a settlement are at stake, the fairness of the settlement to the settling parties is not enough to earn the judicial stamp of approval."). Despite this Court's guidance, the district court failed to give adequate consideration to the harm to Discover and mistakenly approved an Agreement engineered by Visa and MasterCard to harm Discover's business. *See generally* SPA1-55 (Memorandum and Order). Well-settled precedent in this Circuit requires the reviewing judge to give due consideration to all of the evidence and arguments raised by an objecting third-party like Discover. *In re Master Mates & Pilots Pension Plan & IRAP Litig.*, 957 F.2d at 1026 ("[I]f third parties complain to a judge that a 'decree will be inequitable because it will harm them unjustly, he cannot just brush their complaints aside.'") (quoting *Donovan v. Robbins*, 752 F.2d 1170, 1176 (7th Cir. 1985)). The approval by the court below rested on a clearly-erroneous

understanding of the provisions of the Agreement, as well as the court's disregard of a substantial amount of uncontroverted evidence of harm to Discover.

A. The Agreement Unnecessarily Harms Discover.

Both Class Plaintiff-Appellees and Defendant-Appellees have stated that the purpose of the Agreement was to "unleash competition" and lower pricing in the credit card network services market. A1119 (Defs.' Final Approval Mem.) ("The Visa and MasterCard network rules modifications provided in the settlement will provide merchants with additional ways to steer customer to use other brands and forms of payment . . .."); A1121 (Pls.' Final Approval Mem.) (settlement will "encourage customers to use less-costly payment methods and brands . . . and make the payment card market more competitive"). Discover, which has a long history of offering merchants lower pricing than either Visa or MasterCard, would like nothing more than for merchants to have the ability to steer transactions to the lowest-cost payment card network. But this goal can be accomplished without having the Agreement dictate Discover's relationships with its merchants.

First, because of the labyrinthine provisions of the Agreement, the choice by any merchant to accept a network other than Visa or MasterCard will increase that merchant's costs. If a merchant decides to initiate acceptance of, or continue to accept, credit cards from a rival network, it will face the various additional restrictions on surcharging imposed in the Agreement. These additional

restrictions create incentives not to accept rival networks. The net effect will be to raise costs for rival networks to maintain and increase acceptance, leading to lower merchant acceptance or the need to compensate the merchant for its increased costs. The result will be lessened competition and a more dominant Visa and MasterCard, the opposite of what the Agreement is trying to achieve.

Second, and contrary to Visa and MasterCard's assertions, they do not "need" the Level Playing Field Rules. It is incredible that Visa and MasterCard, networks that together account for 70% of credit and charge card transactions, would argue that the Level Playing Field Rules are needed to protect them from Discover, a network with only a 6% share. Visa and MasterCard claim that without the Level Playing Field Rules, they would be potentially disadvantaged by a higher-priced competitor. [redacted]

Third, the Level Playing Field Rules are not an integral part of the Agreement, and Discover can easily be removed from the definition of a

Competitive Credit Card Brand without affecting the Agreement's purpose — to curb the anti-competitive practices of Visa and MasterCard, including their prohibitions against steering. The class merchants supported this result, but Visa and MasterCard opposed it. *See* A2579-80 (9/12/13 Fairness Hearing Tr.).

B. The District Court Did Not Adequately Consider Discover's Concerns and Relied on a Clearly Erroneous Understanding of How the Level Playing Field Rules Function.

The district court devoted a mere four sentences of its memorandum opinion approving the Agreement to Discover's objections. Nowhere did the court address Discover's argument that the Agreement was an illegal group boycott in violation of Sherman Act Section 1, as outlined below, *see infra* pp. 47-49. The district court also ignored the bulk of Discover's arguments and instead summarized Discover's argument as a request to "reject the settlement because its 'Equal Treatment Rule' will be harmed" by the Level Playing Field Rules. This is a mischaracterization of Discover's objection. The district court failed to understand how the Agreement harms Discover — regardless of the Equal Treatment Rule — by placing special burdens on merchants that accept Discover. Instead, the district court relied on its conclusion that "to the extent that Discover cards are lower-priced than Visa and MasterCard products, Discover will not be affected by the level-playing-field provision." SPA50 (Memorandum and Order). That conclusion is clearly erroneous. As discussed above, *see supra* pp. 22-27, the Cost

of Acceptance Exception creates an apples-to-oranges comparison by calculating Discover's cost of acceptance differently that the supposedly-equivalent cost of acceptance for Visa and MasterCard. The Agreement's cost comparison is rigged so that Discover will almost always appear more expensive than Visa and MasterCard, even if it actually is a lower-cost network to merchants.

II. THE DISTRICT COURT IMPROPERLY GRANTED FINAL APPROVAL TO A SETTLEMENT AGREEMENT THAT VIOLATES SECTION 1 OF THE SHERMAN ACT.

When challenging a district court's approval of a settlement agreement, "the appellant must show … that the rules of law for which she is contending are so clearly correct that it was an abuse of discretion for the district court to approve the settlement." *W. Va. v. Chas. Pfizer & Co.*, 440 F.2d 1079, 1086 (2d Cir. 1971). Under the Agreement, Visa and MasterCard have entered into an agreement whereby they will refuse to deal with any merchant unless that merchant implements surcharging in a manner dictated by them and that will disadvantage Discover, a rival competing network. These Level Playing Field Rules imposed by Visa and MasterCard lay out the terms on which Visa and MasterCard will deal with merchants as it relates to surcharging. As such, the Level Playing Field Rules are an agreement among competitors specifically designed to limit the way in which rival networks can compete with Visa and MasterCard. Such an agreement

constitutes a group boycott or collective refusal to deal that is *per se* illegal under Sherman Act § 1.

A. Courts Have Long Found Boycotts in Which a Group of Competitors Use Their Dealings with Suppliers or Customers to Disadvantage Rivals to Be *Per Se* Illegal.

A boycott or concerted refusal to deal "refers to any situation where two or more firms agree not to deal with some other party or to restrict the terms under which they will deal." XII Areeda & Hovenkamp, *Antitrust Law* ¶ 1901e, at 231 (3d ed. 2011); *see also Volvo N. Am. Corp. v. Men's Int'l Prof'l Tennis Council*, 857 F.2d 55, 73 (2d Cir. 1988) ("Generally, a group boycott is 'an agreement by two or more persons not to do business with other individuals, *or to do business with them only on specified terms*.'") (emphasis in original).

Certain types of group boycotts — where a group of competitors use their dealings with suppliers or customers to disadvantage rivals — have long been held *per se* illegal by courts. *See, e.g., Fashion Originators Guild of Am. v. FTC*, 312 U.S. 457, 467-68 (1941); *E. States Retail Lumber Dealers' Ass'n v. United States*, 234 U.S. 600, 614 (1914); *United States v. Crescent Amusement Co.*, 323 U.S. 173, 183-84 (1944). As the Supreme Court noted in *Nw. Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, "[c]ases to which this Court has applied the *per se* approach have generally involved joint efforts by a firm or firms to disadvantage competitors by 'either directly denying or persuading or coercing suppliers or

customers to deny relationships the competitors need in the competitive struggle.'" 472 U.S. 284, 294 (1985); *see also FTC v. Indiana Fed'n of Dentists*, 476 U.S. 447, 458 (1986) (noting that *per se* treatment applies to group boycotts in "cases in which firms with market power boycott suppliers or customers in order to discourage them from doing business with a competitor").

This focus of a group boycott on competitors is the hallmark of a *per se* illegal group boycott. Thus, the Second Circuit has stated that the classic model of an illegal group boycott is a "concerted attempt by a group of competitors at one level to protect themselves from competition from non-group members who seek to compete at that level." *Bogan v. Hodgkins*, 166 F.3d 509, 515 (2d Cir. 1999); *see also Topps Chewing Gum, Inc. v. Major League Baseball Players Ass'n.*, 641 F. Supp. 1179, 1187 (S.D.N.Y. 1986) (noting that a classic group boycott exists when a "group of businesses combine to exclude *other competitors or potential competitors from their level of the market*") (emphasis in original).[14] In a *per se* illegal group boycott, this disadvantaging of rival firms is accomplished through conditioning the group's dealings with suppliers or customers, *i.e.*, the boycotting firms only agree to deal with customers if they agree to terms that disadvantage

[14] The *per se* group boycott rule is not applied if the concerted refusal to deal is aimed entirely at customers, which is better understood simply as a horizontal restraint more akin to a cartel, not an illegal group boycott. *See Indiana Fed'n of Dentists*, 476 U.S. at 458 (viewing an agreement among dentists not to submit x-rays to insurers as something akin to a group boycott, but not something that fits the classic model of a group boycott because it was not aimed at competitors); *see generally* XII Areeda & Hovenkamp, Antitrust Law ¶ 1901e, at 231-32 (discussing how concerted refusals to deal akin to cartels should be distinguished from illegal group boycotts).

rivals. *See Nw. Wholesale Stationers*, 472 U.S. at 294; *NYNEX Corp. v. Discon, Inc.*, 525 U.S. 128, 135 (1998) (describing a group boycott in the "strongest sense" as having occurred when a "group of competitors threatened to withhold business from third parties unless those third parties would help them injure their directly competing rivals").

B. The Undisputed Facts Demonstrate that Visa's and MasterCard's Agreement on the Level Playing Field Rules Constitutes a Group Boycott Directed at Competitors such as Discover and Is *Per Se* Illegal.

Through the Agreement, Visa and MasterCard jointly propose to impose on merchants a requirement that they only implement surcharging consistent with the Level Playing Field Rules. These Level Playing Field Rules, as the very name connotes, are directed toward competition from rival networks and seek to limit the ways in which merchants can deal with rival networks in terms of their surcharging practices. *See supra* pp. 14-21. The result will be higher costs and disadvantages imposed on smaller rival networks such as Discover, lessening competition. As just discussed in the prior section, that is the fact pattern of a classic *per se* illegal group boycott.

Of course, although Visa and MasterCard claim that the rules create the "level playing field" promised by that name, the reality is quite different. As demonstrated by the rigged cost comparison that makes the Agreement's supposed Cost of Acceptance Exception to the Level Play Field Rules impossible to satisfy,

see supra pp. 22-27, the intent of the rules was anything but achieving a "level playing field." In fact, the practical effect is to impose costs on Discover's dealings with rival networks, disadvantaging Discover in the marketplace. Visa and MasterCard thus are not creating a "level playing field," they are seeking to tilt the field to their advantage. Such joint action is not legal under the Sherman Act.

C. The Undisputed Facts Distinguish the Present Case from Situations Where Courts Have Limited the Scope of *Per Se* Review of Group Boycotts.

The facts here distinguish this case from the situations where courts have declined to apply a *per se* rule of illegality to collective refusals to deal. The *per se* doctrine has been limited in circumstances where the collective refusal to deal relates to an economic integration among competitors such as a joint venture or where there are plausible pro-competitive benefits being achieved due to the cooperation among competitors. None of that is the case here.

Legal collective refusals to deal are limited to circumstances where there are pro-competitive benefits. For example, refusals to deal ancillary to a joint venture achieving integrative efficiencies can be assessed under the rule of reason and are possibly legal. *See Brenner v. World Boxing Council*, 675 F.2d 445, 454-455 (2d Cir. 1982) (rejecting applying the *per se* rule in the context of sports leagues and associations given the efficiencies and justifications that exist for joint conduct in

those contexts); *Nw. Wholesale Stationers*, 472 U.S. at 294 (*per se* treatment has been applied when practices "generally not justified by plausible arguments that they were intended to enhance overall efficiency and make markets more competitive"). Similarly, in the context of purchasing cooperatives and collective decisions to deny membership, those membership policies will be analyzed under the rule of reason, rather than a *per se* rule, because the membership rules are integral to cooperative arrangements designed to "increase economic efficiency" and render markets "more, rather than less, competitive." *Nw. Wholesale Stationers*, 472 U.S. at 296 (noting how, given the underlying efficiencies, the "act of expulsion from a wholesale cooperative does not necessarily imply anticompetitive animus and thereby raise a probability of anticompetitive effect").

Nothing in the present Agreement generates the type of joint efficiencies that could justify a collective refusal to deal. Visa and MasterCard are not combining assets in a joint venture that will achieve manufacturing or other efficiencies or developing a new product. Nor are Visa and MasterCard forming an association with efficiencies and thus needing to establish membership rules such as in *Nw. Wholesale Stationers*. The Level Playing Field Rules are not necessary to the Agreement or to achieving any of the desired benefits in terms of removing limits on surcharging.

Instead, as the very name suggests, the Level Playing Field Rules are a form of protectionism, where Visa and MasterCard are seeking to protect themselves against competition from smaller rivals in the new competitive environment that will permit surcharging. In such a situation, a collective refusal to deal is "likely to have predominantly anticompetitive effects" and therefore is a *per se* illegal group boycott. *Id.* at 298.

CONCLUSION

For the foregoing reasons, this Court should reverse the district court's order granting final approval of the Agreement and remand with instructions to modify the Level Playing Field Rules of the Agreement to exclude Discover from the scope of those rules.

June 16, 2014

Respectfully submitted,

/s/ Jennifer M. Selendy

William H. Pratt
Jennifer M. Selendy
KIRKLAND & ELLIS LLP
601 Lexington Avenue
New York, New York 10022
Telephone: (212) 446-4800

Attorneys for DFS Services LLC, Discover Home Loans, Inc., and Discover Bank

CERTIFICATE OF TYPE-VOLUME COMPLIANCE

The undersigned certifies that the foregoing brief is proportionately spaced, has a typeface of 14 points or more, and contains 11,089 words, as authorized by this Court's order of May 27, 2014.

/s/ Jennifer M. Selendy

William H. Pratt
Jennifer M. Selendy
KIRKLAND & ELLIS LLP
601 Lexington Avenue
New York, New York 10022
Telephone: (212) 446-4800

Attorneys for DFS Services LLC, Discover Home Loans, Inc., and Discover Bank

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The undersigned hereby certifies that:

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/s/ Jennifer M. Selendy

William H. Pratt
Jennifer M. Selendy
KIRKLAND & ELLIS LLP
601 Lexington Avenue
New York, New York 10022
Telephone: (212) 446-4800

Attorneys for DFS Services LLC, Discover Home Loans, Inc., and Discover Bank